

Message Text

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P 011658Z MAY 78
FM SECSTATE WASHDC
TO AMEMBASSY ROME PRIORITY

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E.O. 11652:N/A

TAGS: EFIN

SUBJECT: INCOME TAX TREATY NEGOTIATIONS
FOR: CIRO DEFALCO
REF: STATE A-1577

1. PLEASE DELIVER TO MR. MONACHI THE FOLLOWING LETTER
EXPLAINING THE PRINCIPAL DIFFERENCES BETWEEN THE REVISED
DRAFT TEXT OF APRIL 1978 AND THE DRAFT USED IN DECEMBER
1977 NEGOTIATIONS:

"DEAR MR. MONACHI:

I LOOK FORWARD TO THE CONTINUATION OF OUR TAX TREATY
NEGOTIATIONS IN ROME DURING THE WEEK OF MAY 8, AND AM
HOPEFUL THAT WE WILL BE ABLE TO RESOLVE DURING THOSE
MEETINGS THE REMAINING OPEN ISSUES. I HAVE ASKED CIRO
DEFALCO OF OUR EMBASSY IN ROME TO TRANSMIT TO YOU COPIES OF
A REVISED DRAFT TREATY TO BE USED AS THE BASIS FOR THOSE
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DISCUSSIONS.

THE DRAFT REMAINS INCOMPLETE AND IS NECESSARILY
TENTATIVE ON MANY POINTS. IT OMITS SOME IMPORTANT ISSUES,
SUCH AS ITALY'S NEW DIVIDEND TAX CREDIT WITH RESPECT TO
DIVIDENDS PAID TO U.S. SHAREHOLDERS. AND A NUMBER OF OTHER

ISSUES REMAIN OPEN FOR FURTHER DISCUSSION. HOWEVER, WE HAVE DRAFTED TENTATIVE PROVISIONS FOR MANY OF THE OPEN ISSUES TO HELP FOCUS OUR DISCUSSIONS. I WOULD LIKE TO POINT OUT THE PRINCIPAL CHANGES IN THE NEW DRAFT FROM THE DRAFT USED IN THE NEGOTIATIONS HELD IN WASHINGTON IN DECEMBER 1977.

IN PARAGRAPH 3 OF ARTICLE 4 WE HAVE RE-INSERTED THE RULE AGREED UPON LAST APRIL THAT A CORPORATION CREATED UNDER THE LAWS OF ONE OF THE CONTRACTING STATES, BUT WHICH DERIVES MORE THAN 80PERCENT OF ITS GROSS INCOME FROM THE OTHER CONTRACTING STATE, WILL BE CONSIDERED A RESIDENT OF THE LATTER STATE. ALTHOUGH WE INDICATED LAST DECEMBER THAT WE COULD NO LONGER ACCEPT THIS RULE, WE HAVE NOW DECIDED THAT IT IS A WORKABLE RULE IF IT IS COUPLED WITH A NEW PROVISION IN PARAGRAPH 2(C) OF ARTICLE 1 THAT GIVES EACH STATE THE RIGHT TO TAX ITS CORPORATIONS EVEN THOUGH THEY MAY BE RESIDENTS OF THE OTHER STATE. WE BELIEVE THESE TWO RULES ACCOMPLISH THE OBJECTIVES OF BOTH COUNTRIES AND ARE PREFERABLE TO LEAVING THE DETERMINATION OF THE RESIDENCE OF CORPORATIONS TO THE COMPETENT AUTHORITIES.

IN ARTICLE 5 WE HAVE MADE TWO CHANGES. ONE IS TO PROVIDE A RULE IN PARAGRAPH 2(H) WHICH WOULD ALLOW ITALY TO TREAT AS A PERMANENT ESTABLISHMENT THE MAINTENANCE OF SUBSTANTIAL EQUIPMENT IN ITALY FOR MORE THAN SIX MONTHS LIMITED OFFICIAL USE

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BY A RESIDENT OF THE UNITED STATES. A COMPLEMENTARY RULE IS PROVIDED IN ARTICLE 7, PARAGRAPH 8, WHICH SPECIFIES THAT INCOME FROM THE RENTAL OF TANGIBLE PERSONAL PROPERTY IS PROFIT. THUS, ITALY WOULD BE ALLOWED TO TAX SUCH RENTAL INCOME UNDER THESE RULES, PROVIDED THAT THE EQUIPMENT IS MAINTAINED IN ITALY FOR MORE THAN SIX MONTHS. THE SIX MONTH RULE WOULD COVER THE PRINCIPAL CASES, AND IT REPRESENTS A BROAD CONCESSION BY COMPARISON WITH THE PAST PRACTICE OF THE UNITED STATES. THE SECOND CHANGE IN ARTICLE 5 IS THE INSERTION OF THE WORDS "ONE OR MORE" IN THE INTRODUCTORY LANGUAGE OF PARAGRAPH 3. I UNDERSTAND THAT ITALY OBJECTS TO PROVIDING THAT A COMBINATION OF ACTIVITIES WILL NOT CONSTITUTE A PERMANENT ESTABLISHMENT IF EACH ACTIVITY TAKEN INDIVIDUALLY WOULD NOT CONSTITUTE A PERMANENT ESTABLISHMENT; BUT I HOPE THAT ON FURTHER REFLECTION YOU WILL BE ABLE TO AGREE TO THE RULE AS NOW DRAFTED.

IN ARTICLE 10 WE HAVE DELETED PARAGRAPH 5(C), WHICH PERMITTED THE UNITED STATES TO IMPOSE TAX ON DIVIDENDS PAID BY AN ITALIAN CORPORATION WHICH DERIVED MORE THAN 50 PERCENT OF ITS GROSS INCOME FROM THE UNITED STATES. UNDER

OUR PROPOSED CORPORATE RESIDENCE RULE, SUCH A CORPORATION WOULD BE A RESIDENT OF THE UNITED STATES IF IT DERIVED MORE THAN 80 PERCENT OF ITS GROSS INCOME FROM THE UNITED STATES. THUS WE ARE GIVING UP OUR TAX WHEN THE PAYING CORPORATION DERIVED BETWEEN 50 AND 80 PERCENT OF ITS GROSS INCOME FROM THE UNITED STATES. WE HAVE ALSO ADDED A SOURCE RULE FOR DIVIDENDS IN PARAGRAPH 6 OF ARTICLE 10.

SIMILARLY, IN ARTICLE 11 WE HAVE DELETED PARAGRAPH 7(C), WHICH PERMITTED THE UNITED STATES TO TAX INTEREST PAID BY AN ITALIAN CORPORATION WHICH DERIVED MORE THAN 50 PERCENT OF ITS GROSS INCOME FROM THE UNITED STATES. THE REASONING IN THIS CASE IS PARALLEL TO THAT IN THE DIVIDEND LIMITED OFFICIAL USE

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ARTICLE.

IN ARTICLE 12, WE HAVE PROVIDED IN PARAGRAPH 5 THAT THE SOURCE OF ROYALTIES DEPENDS ON WHERE THE RIGHT OR PROPERTY IS USED, RATHER THAN ON THE PLACE WHERE THE PAYMENT ORIGINATES. I RECOGNIZE THAT YOU HAVE SOME DIFFICULTY WITH THIS RULE, BUT I HOPE THAT YOU WILL BE WILLING TO RECONSIDER IT. IT IS A POINT OF SOME IMPORTANCE TO US.

THESE ARE THE PRINCIPAL POINTS WE HAVE CHANGED SINCE OUR LAST DISCUSSION. WE LOOK FORWARD TO DISCUSSING THEM WITH YOU IN MAY.

WITH BEST REGARDS.

SINCERELY, H. DAVID ROSENBLOOM,
INTERNATIONAL TAX COUNSEL" VANCE

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